United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

75-7095

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To be argued by
EDWARD J. ROSS

United States Court of Appeals
For the Second Circuit

JAY HANDWERGER,
Plaintiff-Appellee,

against

CHARLES GINSBERG, JR., DAVID WEINTRAUB, ABRAHAM WEINTRAUB, ALAN R. CARP, JAMES T. SANDLER, A. THEODORE BARRON, STANLEY FROST, EDWARD GINSBERG, NOAH GOLDBERG, JOHN W. HURLEY, ALLAN LAZAROFF, SANFORD L. ROSENBERG, HEINZ SCHNEIDER, ROBERT B. SEGAL, MARTIN UNGER, AARON WEINTRAUB, HARRY WEINTRAUB, SANITAS SERVICE CORPORATION,
Defendants,

ARTHUR ANDERSEN & CO.,
Defendant-Appellant.

Appeal from the United States District Court for the Southern District of New York

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BRIEF FOR DEFENDANT-APPELLANT ARTHUR ANDERSEN & CO.

BREED, ABBOTT & MORGAN
One Chase Manhattan Plaza
New York, New York 10005

EDWARD J. ROSS
JAMES D. ZIRIN
Of Counsel

WILSON & McILVAINE
135 South LaSalle Street
Chicago, Illinois 60603

Attorneys for Defendant-Appellant Arthur Andersen & Co.

CHARLES W. BOAND
Of Counsel

Annual Report. His then existing holdings of 150 shares

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TABLE OF CONTENTS

PAGE

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TABLE OF AUTHORITIES

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Preliminary Statement

This is an appeal from a decision and order of Hon. Henry F. Werker, D.J., entered January 2, 1975 (59A-64A),* not officially reported,** which held that this action could be maintained as a class action and that plaintiff, a debenture holder, could represent a class consisting of all

* Numbers with suffix "A" refer to pages of Joint Appendix.

** The opinion is reported in full text in CCH, Fed.Sec.L.Rep., ¶94,934, p. 97,239.

the class due to the fact that the interests of debenture

other debenture holders and also all stockholders. The order is appealable under *Herbst* v. *International Telephone & Telegraph Corp.*, 495 F.2d 1308 (2d Cir. 1974) and *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156 (1974).

Statement of the Issues Presented for Review

(1) Can a holder of debentures of a corporation represent a class consisting not only of all other debenture holders but also all stockholders, where the corporation has been progressively losing money and appears to be on the verge of insolvency?

(2) Is Rule 23(b)(3) invalid in that it abridges and modifies substantive rights in violation of 28 U.S.C. §2072 and extends the jurisdiction of the District Court in violation of Rule 82?

(3) Is Rule 23(b)(3) and (c)(2), (3) invalid in that it purports to bind persons to a judgment in an action maintained as a class action by a notice procedure which violates due process?

(4) Should this Court exercise its inherent power to dismiss the action as entirely void of merit?

Statement of the Case

Nature of the Case

This action was commenced on November 12, 1973 (1A) as a class action by plaintiff Handwerger, who "purchased $5,000 principal amount of convertible debentures of defendant Sanitas Service Corporation ('Sanitas') on or about January 23, 1973" (3A), in reliance on its Annual Report for the year ending June 30, 1972 (3A).

Prior to such purchase, plaintiff already owned 150 shares of Sanitas and three debentures, aggregating $3,000

(18A). Accordingly, he was sent such Annual Report and was also sent the Proxy Statement for its annual meeting, to be held on October 25, 1972.

The complaint is based on alleged violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10 b-5 and "common law principles" (¶2, 2A). Tracking the language of Rule 10b-5, the complaint charges that a number of statements in the Annual Report and in certain interim reports "were false and misleading in that they contained various untrue statements of material facts and omitted to state other material facts necessary in order to make the statements made not misleading in light of the circumstances under which they were made" (¶15, 7A).

The complaint names as defendants Sanitas itself, its officers and directors and Arthur Andersen & Co. ("Andersen"), the accountants for Sanitas, who rendered an opinion, as alleged in the complaint, "with respect to various financial statements of Sanitas, including the statements appearing in Sanitas' Annual Report for the year ending June 30, 1972" (¶6(b), 3A).

Plaintiff purports to represent a class of security holders of Sanitas consisting "of all persons who purchased securities of Sanitas between June 30, 1972 and June 30, 1973" (¶8, 4A). Included in the same class are both debenture holders and stockholders. Also included in the same class are all persons who purchased and retained their debentures, and those who have already sold their debentures, and all persons who purchased and retained their stock, and those who have already sold their stock. Plaintiff's attorney has estimated that the class consists of approximately 200 debenture holders and 4,000 stockholders (57A-58A).

With respect to his own situation, plaintiff relies solely on his purchase of $5,000 of debentures, made January 23, 1973, in alleged reliance on a misleading omission from the

Annual Report. His then existing holdings of 150 shares of common stock and $3,000 of debentures are not involved in this action, since made before issuance of the Annual Peport containing the alleged omission.

The Course of Proceedings Below

Plaintiff's deposition was taken on May 7, 1974, addressed to issues involved in his acting as the class representative (14A-25A-2).

On July 10, 1974, plaintiff moved for an order "Declaring that this action shall proceed as a class action pursuant to Federal Rule 23" (26A). All defendants urged denial, primarily because plaintiff's interest as a debenture holder was in conflict with the interests of stockholders (see, *e.g.*, 42A).

Disposition in the Court Below

On January 2, 1975, Judge Werker determined that the action may be maintained as a class action with plaintiff, as a debenture holder, representing all stockholders, as well as all debenture holders, who are members of the alleged class. Judge Werker could "see no substantial difference between the claims of the debenture holders and the shareholders in the posture of this case" (62A), but stated that if "questions of conflict of interest * * * develop, then subclasses could be formed pursuant to Rule 23(c)(4)" (62A, fn. 3).

Appeal was taken from such decision and order of Judge Werker (65A).

Statement of the Facts Relevant to the Issues Presented for Review

Sanitas, a Connecticut corporation, with its principal place of business in Hartford (3A), whose securities were traded on the American Stock Exchange (28A), is engaged in the business of solid waste management and building maintenance (38A, 50A). Through one of its operating

divisions, Sanitas conducted an industrial laundering business called "Sanitas' Economy Linen Service Division ('Economy Linen')" (5A), which annually had substantial losses. Such losses adversely affected Sanitas profits, and, according to plaintiff's lawyer, "were a drain on the overall earnings of Sanitas and had a depressing effect on the market price of the securities of Sanitas" (29A).

A. The Disclosure in the Annual Report of an Agreement to Sell Corporate Assets, Without Disclosing That the Purchaser Was a "Limited Partnership"

Prior to Sanitas' annual meeting, noticed for October 25, 1972, plaintiff was sent its Annual Report for the year ended June 30, 1972, and a notice of annual meeting, dated September 29, 1972, accompanied by the Proxy Statement, also dated September 29, 1972. The Annual Report consisted of 32 pages and the Proxy Statement of 8 pages (25A-3, 25A-4-5).

The Annual Report, in footnote 7, on page 31, sets forth information as to Sanitas' agreement to sell the net assets of Economy Linen to "a group of stockholders which includes the president of the Corporation, nine other members of the Board of Directors and certain other stockholders * * * for $1,000,000 in cash and $1,615,569 in promissory notes bearing an interest rate of 7% and due in 32 equal quarterly installments commencing January, 1975" (25A-3). Such Annual Report also advises that "The sale will be consummated on or before January 5, 1973, unless, prior to that date, the Corporation [Sanitas] shall have received a bona fide offer to purchase the division for an amount greater than $2,615,569" (25A-3). Page 1 of the Annual Report states that Sanitas had "entered into an Agreement which gives Sanitas the right to sell, to a partnership which includes several Sanitas officers and directors," substantially all the assets of Economy Linen (25A-3b).

While the complaint contains a number of allegations as to the false and misleading nature of the Annual Re-

port (5A-7A), plaintiff really has only one basic grievance, as alleged in paragraph 12(b) of the complaint. It is his position that there was a fraudulent omission from the Annual Report because the information therein as to the agreement to sell Economy Linen to such directors and stockholders failed to disclose that "the sale was actually made to a *limited partnership** in which the aforementioned persons were merely limited partners with limited capital and limited liabilities" (6A). Thus, "Plaintiff's Reply Memorandum in Support of His Motion for Class Determination," received November 2, 1974, states (pp. 6-7):

> "There is really *only a single issue* of a substantive nature. That involves the misleading nature and the market impact of defendants' failure to disclose that the 'partnership' of substantial persons to which Sanitas allegedly sold its only non-profitable division, Economy Linen, was in reality a limited partnership."

Plaintiff has been a lawyer for sixteen years, employed successively by two law firms known to be active in securities litigation, primarily representing plaintiffs in class actions and 10b-5 cases (14A-15A). This knowledgeable plaintiff testified that he read the 32-page Annual Report, including footnote 7 on page 31 quoted in the complaint (5A-6A), and, misled by its omission to disclose "that the sale was actually made to a limited partnership" (Cplt. ¶12(b), 6A), bought his $5,000 debentures and was accordingly defrauded (24A). As he complained, "they should have told me fully that the sale of this Detroit linen plant was to a limited partnership"; "They should have told it to me in Exhibit 5 [the 3 months interim report, as on September 30, 1975], as well as other literature * * *. Also, in the annual report" (25A-1; 25A-2).

Plaintiff explained why he deemed omission from the Annual Report specifically to disclose that the sale "was actually made to a limited partnership" to be so significant (20A-1):

> "A. Well, if you are selling to a limited partnership of whom only one general partner is liable and the lim-

* Unless otherwise noted, italics throughout have been supplied.

ited partners invest nothing, it is obvious that there is doubtful collectibility, especially when the limited partners may have limited assets''.*

However, as already noted, when plaintiff received the 32-page Annual Report, he also received the 8-page Proxy Statement. While he was vague as to whether they came together,—testifying he ''would imagine'' that he saw ''the notice of meeting and proxy statement at or about the same time'' as he ''saw the annual report,''—it was his ''best recollection'' that ''they probably arrived in my house within a week or so of each other, if not at the same time'' (24A).

Since the Sanitas management proposed reelection of the directors who had made such agreement with Sanitas to buy Economy Linen for $1,000,000 in cash and $1,615,509 in 7% notes, payable in 32 equal quarterly installments, full disclosure of such agreement in the Proxy Statement was essential. Accordingly, the disclosure there made was even more detailed than in the Annual Report. In the 32-page Annual Report, the disclosure in footnote 7, on page 31, contained 19 lines of text. In the 8-page Proxy Statement, the disclosure, on pages 7 and 8, contained 44 lines of text.

The Proxy Statement disclosure commenced with the statement that ''On September 14, 1972, the Corporation entered into an Agreement with *a limited partnership*'' to sell Economy Linen for $2,615,569. It then stated that ''Among the members of *the limited partnership* are the following directors and officers of the Corporation,'' giving their names and titles.

The 44 lines of disclosure are somewhat repetitious in their reference to the limited partnership, advising, for example, that ''None of the directors who are members of *the limited partnership* will have voted on any resolution of the Corporation's Board of Directors relating to this

* Plaintiff's statement,—particularly coming from a seasoned lawyer,—is absurd on its face in that general partners also ''may have limited assets.''

matter." The Proxy Statement contains 13 references to "the limited partnership" and to "the partnership," the latter term clearly referring to the "limited partnership" (25A-4-5).

Since plaintiff received both the Annual Report, with its 19-line description of the transaction and omission to state that the buyer was a limited partnership or even a partnership, and the Proxy Statement, with its 44-line description of the identical transaction, with its numerous specific references to "limited partnership" and "partnership," he was hard pressed to support his position of a fraudulent omission by the Sanitas management to disclose that its agreement to sell Economy Linen was to a limited partnership. Accordingly, he was forced into claiming that he was misled when he bought his $5,000 of debentures solely because of the omission in the Annual Report to disclose that the sale was to a limited partnership, and that he could not recall reading the portion of the Proxy Statement which so clearly and so repetitively disclosed that the buyer was a limited partnership.

As to his failure to note such statement in the Proxy Statement, plaintiff testified (25A):

> "A. I did not kno.., even though the notice of annual meeting contained something *in the rear portion* stating that it was sold to a limited partnership; that did not strike a bell with me at that time. In fact, I don't remember reading that particular portion."

Subsequently, when shown such explicit and repetitious statement on page 7 of the Proxy Statement that the agreement had been made "with a limited partnership," this lawyer, seasoned in securities litigation, testified (25A):

> "A. As I previously testified, I don't remember reading this particular paragraph or that particular sentence."

It is, of course, difficult to give credence to plaintiff's excuse that he missed such references in the Proxy State-

ment to the purchaser being a "limited partnership," because contained "in the rear portion," namely, pages 7-8 (25A), especially since the omission to disclose, of which he complains as fraudulent, also appeared "in the rear portion" of the Annual Report,—namely, in a footnote on page 31.

It is this plaintiff who, claiming to have been fraudulently misled by the omission of the Annual Report to describe the buyer as a "limited partnership", seeks to represent all other debenture holders, as well as all other stockholders, who he claims were similarly misled.*

B. The Financial Condition of Sanitas at the Commencement of the Action, Which Especially Makes It Inappropriate for a Debenture Holder Also to Represent All Stockholders

In a flourishing corporation with no problem of meeting current obligations and with assets adequate to meet all debt obligations, the potential conflict of interest between debenture holders and stockholders, while inherently present, obviously has less impact than in the case of a corporation whose assets are barely adequate to cover its debentures and other indebtedness. Accordingly, it is relevant to describe Sanitas' financial situation since plaintiff, as a debenture holder, has been designated to represent all stockholders.

Sanitas' SEC Form 10-Q shows that for the nine months ending March 31, 1974, it lost $997,000 (45A). It also shows that its total debt was $39,499,578, of which the debentures constituted $8,205,000 (48A). Of such indebtedness,

* A derivative action asserting that the officers and directors of Sanitas made an improvident sale of corporate assets by selling to a limited partnership which lacked financial responsibility to pay the notes given as part of the purchase price, was promptly brought in the District Court in Connecticut and is now pending (*Lacon* v. *Ginsberg* (D.Conn. Doc. No. B856)). This appears to be the real position of plaintiff, which is not a basis for a class action.

$14,300,000 was owed four banks. On February 14, 1974, Sanitas announced its inability to pay $400,000 interest and $250,000 principal on such indebtedness, due March 31, 1974 (50A).

As part of its credit agreement with such banks, Sanitas also had to maintain an asset-to-liability ratio of 1.1 to 1, but fell below this ratio in violation of such provision (50A), —an additional basis for a default on such $14,300,000 bank indebtedness.

Sanitas' fortunes continued to decline, as shown by its release, dated September 17, 1974 (53A-55A). Its net loss, which for nine months ending March 31, 1974 was $997,000, became $5,500,000 for the year ending June 30, 1974 (53A).

The release also states that Sanitas "is engaged in a program of disposing of certain of its assets for the purpose of improving its financial posture", and that,

> "At the present time, the Corporation is in the process of completing the sale of five of its operations which are scheduled to close on or before September 30, 1974, and are anticipated to yield aggregate cash proceeds of $1,030,000.
>
> "At the present time, the Corporation *is not generating sufficient internal cash flow to meet the principal and interest requirements of its major debt obligations*" (54A).

Because of Sanitas' financial condition, on September 17, 1974, the SEC suspended trading in its shares (56A, 58A).

The affidavit of plaintiff's attorney, sworn to October 30, 1974, states that "As of October 25, 1974, there was no bid whatsoever for the common stock which was *offered* at approximately $.37 per share" in the over-the-counter market (58A). Judge Werker, referring to this "trading halt in the securities", said that the stock "may be *sold* over the

counter at * * * $.37 per share'' (61A),—overlooking the fact that 37 cents per share was not the price at which the stock could be ''sold'', but merely the price at which it was ''offered''. But there were no buyers at such price.

Judge Werker also recognized that ''debenture holders have first call as creditors'', but felt that ''difference in rights *in the event of insolvency* cannot prejudice the separate and independent rights of redress for fraud'' (63A). However, Judge Werker, in thus regarding insolvency as merely a future event, overlooked the fact that on January 2, 1975, when he made his decision, there was obviously no equity for stockholders who could find no buyers at even 37 cents a share.

POINT I

The interests of creditors are presently and potentially in conflict with the interests of stockholders, especially since Sanitas' assets are barely sufficient to cover its debts, so that the stock would appear to be valueless. Accordingly, the District Court improperly determined a class consisting of both debenture holders and stockholders, represented by plaintiff.

It is basic in a class action that a member of a class may not represent either conflicting or potentially conflicting interests. Shortly after promulgation of revised Rule 23 (b)(3) in 1966, this Court, referring to the new class actions, stated that ''Since all members of the class are to be bound by the judgment, diverse and potentially conflicting interests within the class are incompatible with the maintenance of a true class action.'' *Carroll* v. *American Federation of Musicians*, 372 F.2d 155, 162 (2d Cir. 1967).* If plaintiff, a debenture holder, represents stockholders who do not elect to exclude themselves, then such stockholders will, of course, be bound by the judgment. ''A much stricter standard for determining the adequacy of representation should obtain where there are non-intervenors who would be bound by the judgment''. (*Carroll* v. *American Federation of Musicians, supra,* at 162).

* Vacated on other grounds, 391 U.S. 99 (1968).

For this reason, as noted in *Dolgow* v. *Anderson*, 43 F.R.D. 472, 493 (E.D.N.Y. 1968), "The question of adequacy of representation is of greater significance under the new rule than under the old".

In *Free World Foreign Cars, Inc.* v. *Alfa Romeo S.p.A.*, 55 F.R.D. 26, 29 (S.D.N.Y. 1972), Judge Weinfeld, in denying class action status, held that Rule 23(a) "requires that the purported representative have common interests with its members and that *there be no existing or potential conflict of interest*". See also, *Ruggiero* v. *American Bioculture, Inc.*, 56 F.R.D. 93, 95 (S.D.N.Y. 1972); *Guttmann* v. *Braemer*, 51 F.R.D. 537, 538 (S.D.N.Y. 1970).

The distinction between a creditor and a stockholder is so basic, and their interests are normally so disparate and diverse, particularly as to corporations in shaky financial condition, that they present the classic case of diametrically opposed interests. Thus, in *In re Phoenix Hotel Co. of Lexington, Ky.*, 83 F.2d 724, 726 (C.C.A. 6th, 1936), *cert. denied*, 299 U.S. 568 (1936), the Court stated:

> "It is a fundamental rule of corporation law that one cannot be at the same time both a stockholder and a creditor of a corporation in respect to the same funds hazarded in the corporate enterprise. *The two relations are antipodal.* This principle is not only rooted in sound public policy, but grows out of the very nature of corporations."

As stated in *Woods* v. *City National Bank and Trust Co.*, 312 U.S. 262, 265 (1941),—in referring to a party interested in the equity also representing first mortgage bonds in a Chapter X reorganization,—"the equity owner is peculiarly ill-suited to represent the mortgagee in these situations because of *their historic clash of interests.*" See also, *J.P. Morgan & Co.* v. *Missouri Pac. R. Co.*, 85 F.2d 351, 352 (C.C.A. 8th, 1936), *cert. denied*, 299 U.S. 604 (1936).

The foregoing,—which has always characterized the basic distinction between the position of a creditor and the

position of a stockholder,—necessarily applies to class actions, especially those involving a corporation whose net assets are insufficient to leave anything for stockholders.

Accordingly, in *Carlisle* v. *LTV Electrosystems Inc.*, 54 F.R.D. 237, 239 (N.D. Tex. 1972), the court denied class action status where the named plaintiff sought to represent both debenture holders and stockholders because "the debenture holders and the stockholders have differing rights, and the considerations motivating purchase of debentures are very different from the considerations motivating purchase of stocks".

Herbst v. *Able*, 278 F.Supp. 664, 668, fn. 6 (S.D.N.Y. 1967), noted that no plaintiff in any of the four pending class actions "alleges purchase of any security other than the debentures", and stated that "Indeed, the interests of the debenture holders might be in conflict with the interests of the holders of other Douglas securities".

Judge Werker cited *Fischer* v. *Kletz*, 41 F.R.D. 377 (S.D.N.Y. 1966), to support his statement that there was "no substantial difference between the claims of the debenture holders and the shareholders in the posture of this case" (62A, fn. 3). However, in that case, which involved 18 separate actions, certain plaintiffs, who were in the Bloch action and represented only debenture holders, found a conflict with plaintiffs who represented stockholders. The court there recognized the "possible conflict of interests among the security-holders who are maintaining these actions". It stated, "Specifically, there is some indication of adverse interests of the common stockholders and the debenture holders" (41 F.R.D. at 384).

Although the cases were allowed to proceed as a class action, it was on the basis that in one case (the Bloch action), the plaintiffs represented debenture holders only, whereas in another action the plaintiffs sought to represent both common stock and debenture buyers. Accordingly, the court, noting "the possible conflict between the deben-

ture and common stock holders" directed "counsel for the two potentially adverse interests to attempt to reconcile any differences" (41 F.R.D. at 384).

This is substantially different from the situation at bar, where debenture holders and stockholders are not separately represented, and where there is only one plaintiff and only one counsel who seeks to represent both debenture holders and stockholders, despite what *Fischer* v. *Kletz* described as a "possible conflict" and "potentially adverse interests" (41 F.R.D. at 384).

In *Green* v. *Wolf Corporation*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969), upon which Judge Werker also relied (62A, fn. 3), the plaintiff also represented both purchasers of stock and debentures. However, this Court did not discuss the potential conflict, which does not appear to have been raised by anyone, and merely observed that "We do not perceive, *at this juncture of the case*, any conflict of interest between Green and other members of the class" (p. 298).

Also, the plaintiff Green had there convinced this Court that everyone but Green "would be barred by the Statute of Limitations". This Court was therefore concerned that "to deny a class action under such circumstances would have serious consequences, since all those injured except Green would now have no other remedy, although they may have been relying on Green's class action for their balm" (406 F.2d at 301, fn. 14).*

In *In re Caesar's Palace Securities Litigation*, 360 F. Supp. 366, 398 (S.D.N.Y. 1973), the court rejected a contention that representation by the plaintiff of holders of debentures and common stock "results in a conflict within

* This was before the holding in *American Pipe & Construction Co.* v. *Utah*, 414 U.S. 538, 552-556 (1974), that commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the requirement of Rule 23(a)(1) been met.

the class due to the fact that the interests of debenture holders may differ in many respects from the interest of shareholders." However, unlike the case at bar, the class in *Caesar's Palace* was not composed of both purchasers of stock and purchasers of debentures, but of purchasers of stock and purchasers of debentures "who, thereafter, converted these debt securities into common stock" (*Id.*, at 398). The effect of course was that the plaintiff was representing only stockholders, and not debenture holders.

Here, with debentures convertible into common stock at $8 a share (42A) and with no buyers for the common stock at 37¢ a share (pp. 10-11, *supra*), the convertible feature, though strongly relied on below by plaintiff, has no relevancy and may be ignored.*

Representation of holders of securities through classes determined under Rule 23, and representation through committees in reorganization proceedings, whether in equity or under the Bankruptcy Act, are not dissimilar. *Steere* v. *Baldwin Locomotive Works*, 98 F.2d 889, 892 (CCA 3, 1938) noted that committees of security holders are formed in reorganization proceedings because their holdings "are too small to make possible independent action for their own protection." Similarly, the concept of the class action is also that the holding of the named plaintiff is too small for independent action.

It was basic in corporate reorganizations that stockholders and bondholders could not be represented by the same protective committee. Thus, as already noted, *Woods* v. *City National Bank and Trust Co.*, *supra*, 312 U.S. 262, 265 (1941), stated that one "is particularly ill-suited to rep-

* Plaintiff, to establish that in this case debenture holders and stockholders are not in a position of potential conflict, stressed in his Reply Memorandum below that "the debenture is convertible into common shares so that it has many of the attributes of an equity security"; and that "there is no conflict here, particularly because the debentures were convertible into common" (p. 10). This attempt to equate a convertible debenture with common stock might have some validity if the conversion price was near or below the market price for the stock, but not where the conversion price is $8 a share and the market price is 37¢ a share.

resent" the other "because of their historic clash of interests."

Steere v. *Baldwin Locomotive Works, supra,* 98 F.2d 889, 892 (CCA 3, 1938), stressed that protective committees for securities holders should be "free of conflicting interests and reasonably representative."

The strictness with which courts viewed the requirement in reorganization proceedings that protective committees representing one class of security holders be "free of conflicting interests" is illustrated by *In re Realty Associates Securities Corp.,* 56 F.Supp. 1008, 1009 (E.D.N.Y. 1944), where former representatives of equity interests were deemed "not qualified to act as a committee representing bondholders" because their "past relationship will give rise to conflicting loyalties."

The standards and ethics involved in avoiding actual or potential conflict in representation of creditors and stockholders in class actions should be no less compelling than those involved in committee representation in reorganization proceedings. The basic principle is identical. For, as Judge Mansfield stated in *Guttmann* v. *Braemer, supra,* 51 F.R.D. 537, 540 (S.D.N.Y. 1970), "When a plaintiff seeks to represent a class he becomes a fiduciary with respect to *all* of its members" (italics, the court's).

Since the natural tendency of the District Court in most proposed class actions appears to be to certify the plaintiff as qualified to represent a class if the court deems his counsel to be energetic and experienced in class action litigation, there also appears to be a tendency to gloss over potential conflicts on the theory that they present no problem because when they develop, the court need merely create subclasses. This simple formula thus enables deferral of a troublesome question.

Thus, *Fischer* v. *Kletz, supra,* 41 F.R.D. 377, 384 (S.D. N.Y. 1966), indicated that the solution of "possible conflict

between the debenture and common stock holders'' is to divide the class into subclasses, as authorized by Rule 23 (c)(4)(B). Similarly, in *In re Consolidated Pretrial Proceedings in Ampex Securities Cases*, Docket No. C-72-360 (N.D. Cal., April 10, 1974) (unreported), and relied on by Judge Werker (62A, fn 3), the court determined a class of ''shareholders and debenture holders'' (p. 4) and also indicated that conflicts between the two classes and the many other problems presented thereby ''can be solved with subclasses'' (p. 10).

Judge Werker, taking his cue from these cases, stated that ''If, during the process of the litigation, questions of conflict of interest * * * develop, then subclasses could be formed pursuant to Rule 23(c)(4)'' (62A, fn. 3). Later, he again referred to the possibility of solving the problem by exercising his right to ''designate subclasses'' (63A).

However, Judge Werker lost sight of the basic distinction between *Fischer* v. *Kletz*, and the case at bar. As already noted (p. 13, *supra*) in *Fischer* v. *Kletz*, 18 separate actions had been filed, so that there were 18 separate lawyers representing plaintiffs. Certain actions were brought in behalf of debenture holders only, and others in behalf of stockholders only, each with separate counsel. Accordingly, when the anticipated conflict between debenture holders and securities holders there eventuated, it would be feasible to create subclasses, with a lawyer who had sued in behalf of debenture holders representing all debenture holders as a subclass, and with a lawyer who had sued in behalf of stockholders representing a stockholder subclass. There would be no need to then find a named plaintiff class representative or a lawyer to represent him; the requisite personnel for the subclasses were already before the court.

In the case at bar, however, the situation is inherently different. There is only one named plaintiff who claims to have been injured in his capacity as a debenture holder, and he is represented by one law firm. Assume that in a year or two, after full discovery and the unfolding of the

case, the "historic clash of interests" between debenture holders and stockholders should present a serious conflict requiring subclasses. How does the court then find a named plaintiff and a lawyer to represent the stockholder subclass?

As already noted (p. 6, *supra*), plaintiff Handwerger and his lawyer take the position that this case presents "really only a single issue of a substantive nature"; namely, the alleged omission by Sanitas to disclose that the contract for sale of Economy Linen was made with "a limited partnership". As further noted (p. 7, *supra*), the Proxy Statement so clearly and so repetitively disclosed that the sale had been made to "a limited partnership" that plaintiff had to testify in effect that he was defrauded because he could not remember reading the portion of an 8-page Proxy Statement which had made such full disclosure, since it was "in the rear portion" (p. 8, *supra,* 25A).

To create a subclass at some future date, when the "historic clash of interests" creates a problem, the court must find a plaintiff also willing to take the position that he was defrauded because of such alleged omission to disclose that the sale had been made to "a limited partnership",—when all stockholders were so fully and explicitly advised of this fact,—and justify his position on his failure to read to the end of the 8-page Proxy Statement. The court cannot be certain that such a subclass leader will emerge or that a new lawyer can be found willing to undertake such subclass representation, especially since under *Eisen* v. *Carlisle & Jacquelin, supra,* 417 U.S. 156 (1974), such new plaintiff or new lawyer must pay the full cost of all notices to all 4,000 stockholders, while plaintiff pays for notice to 200 debenture holders. Or can the court appoint counsel, as it might for an indigent defendant; if court appointed, how is such new counsel to be compensated if plaintiffs do not prevail?

Also, will such new lawyer be at a disadvantage in entering the case at a late stage?

Neither plaintiff Handwerger nor his counsel can themselves produce such a new subclass leader and such new counsel, since that would necessarily destroy their requisite independence. Accordingly, the shibboleth of a future subclass relied on by Judge Werker to solve the potential conflict problem is here illusory.

The District Court, in assuming that there is no problem of conflict since a subclass can always be created, has shown inadequate appreciation of the problem. This is further manifest by its designation of plaintiff's counsel as "lead counsel" (64A),—a concept normally used only when there are "a large number of parties represented by different counsel" (Manual for Complex Litigation, Part I, §1.92, p. 73).

POINT II

Under the ABA Code of Professional Responsibility, the same lawyer may not represent conflicting interests or clients with potentially differing interests.

A class representative's fiduciary obligation to all members of the class is no less compelling than that involved in the attorney-client relationship. If plaintiff,—as a debenture holder claiming to have been defrauded by Sanitas' alleged failure to disclose that the sale of Economy Linen had been made to "a limited partnership",—can represent both debenture holders and stockholders, despite a potential conflict of interest, then it necessarily follows that his lawyer must also be able to represent both debenture holders and stockholders, despite the same potential conflict of interest.

However, a lawyer must be especially careful not to represent interests with a potential for being different. The Code of Professional Responsibility of the American Bar Association cautions against a lawyer representing "differing interests, whether such interests be conflicting,

inconsistent, diverse, or otherwise discordant" (EC 5-14). Such Code also stresses that "there are few situations in which he [a lawyer] would be justified in representing in litigation multiple clients with potentially differing interests" (EC 5-15).

There appears to be a dichotomy of approach between a named plaintiff representing members of a class and the Code of Professional Responsibility, as though they involved separate criteria,—ignoring the fact that if the class representative has a potential conflict, then the lawyer he selected to represent him and the class must also have a potential conflict.

The Code of Professional Responsibility requires that when a lawyer faces the possibility of representing "potentially differing interests", "He should resolve all doubts against the propriety of the representation" (EC 5-15). Judge Werker, however, took the contrary view. He resolved all doubts in favor of the representation, on the theory that subclasses could always cure the problem,—an illusory remedy in this case.

In *Ruggiero* v. *American Bioculture, Inc., supra,* 56 F.R.D. 93, 95 (S.D.N.Y. 1972), the court,—unable to see how class plaintiffs "can vigorously seek recovery on behalf of those who have an equity interest in the corporation and, on the other hand vigorously seek recovery from the corporation on behalf of those who have no equity interest in the corporation",—found "a substantial question as to whether the attorneys" for such class plaintiffs could represent them in the two situations "without violating the Canons of Ethics".

Drinker, *Legal Ethics* (1953), the most authoritative text in this field, makes clear that the admonition to lawyers "to avoid the representation of conflicting interests" also applies to the "*possibility* that such a situation will develop" (p. 104).

In *Emle Industries, Inc.* v. *Patentex, Inc.*, 478 F.2d 562, 571 (2d Cir. 1973), this Court recognized that "Even the most rigorous self-discipline might not prevent a lawyer from unconsciously" violating his trust to one client when representing two in a situation of potential conflict. For, as this Court there stressed:

> "The dynamics of litigation are far too subtle, the attorney's role in that process is far too critical, and the public's interest in the outcome is far too great to leave room for even the slightest doubt concerning the ethical propriety of a lawyer's representation in a given case."

POINT III

The Supreme Court lacked the power to prescribe Rule 23, as amended in 1966, since such rule is not limited to "practice and procedure", but abridges and modifies a "substantive right", contrary to 28 U.S.C. §2072.

A. This Court May Consider the Issue of Validity of Rule 23, Though Not Raised Below.

Defendant Andersen presents the issue of validity of Rule 23, as amended in 1966,—an issue not raised below. A court will consider issues not raised below where they "are of great significance" (*Green* v. *Brown*, 398 F.2d 1006, 1009 (2d Cir. 1968)) or where "there are significant questions of general impact" (*Krause* v. *Sacramento Inn*, 479 F.2d 988, 989 (9th Cir. 1973)). See also *Southard* v. *Southard*, 305 F.2d 730, 732 (2d Cir. 1962); *New York, N.H. & H.R.* v. *Reconstruction Finance Corp.*, 180 F.2d 241, 244 (2d Cir. 1950). It is therefore appropriate for this Court to consider the validity of Rule 23,—clearly an issue of "great significance" and "of general impact".

No reported case has ruled on the validity issue, though District Court judges have expressed misgivings, indicating

that Rule 23 constitutes a "radical extension [of] this Court's jurisdiction", is "unprecedented" and can cause a class member to forfeit a "previously unfettered right" (*School District of Philadelphia* v. *Harper & Row Publishers, Inc.*, 267 F.Supp. 1001, 1005 (E.D.Pa. 1967)). Cases such as *American Pipe & Construction Co.* v. *Utah*, *supra*, 414 U.S. 538 (1974) and *Eisen* v. *Carlisle & Jacquelin*, *supra*, 417 U.S. 156 (1974) have ruled on aspects of Rule 23, without considering validity. Accordingly, neither such cases, nor the many decisions in the Courts of Appeal and District Courts which have struggled with the myriad aspects of Rule 23, can be deemed authority for sustaining its validity:

> "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents" (*Webster* v. *Fall*, 266 U.S. 507, 511 (1925)).

B. The Supreme Court's Power to Prescribe Rules Is Limited to "Practice and Procedure" and Such Rules May Not Abridge or Modify a "Substantive Right."

The Supreme Court's power to prescribe rules is governed by 28 U.S.C. §2072,* known as the "Rules Enabling Act." The Supreme Court's rule-making power is limited to rules governing "forms of process, writs, pleadings, and

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* "§2072. Rules of civil procedure

"The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings, and motions, and the practice and procedure of the district courts and courts of appeals of the United States in civil actions, including admiralty and maritime cases, and appeals therein, and the practice and procedure in proceedings for the review by the courts of appeals of decisions of the Tax Court of the United States and for the judicial review or enforcement of orders of administrative agencies, boards, commissions, and officers.

"Such rules shall not abridge, enlarge or modify any substantive right and shall preserve the right of trial by jury as at common law and as declared by the Seventh Amendment to the Constitution * * *."

motions, and the practice and procedure" of the federal courts. There is a strong *caveat* that "Such rules shall not abridge, enlarge or modify any substantive right."

The issue under 28 U.S.C. §2072 thus comes down to whether a change in the Rule from one in which a person may not be bound by a judgment unless he becomes an actual party to the suit, to one in which, by mere notice and failure to opt out, he becomes bound by a judgment, whether favorable or adverse, because represented by a person he did not select, and of whom he may never have heard, and perhaps even without knowing that he was a member of a class,* is merely a matter of "practice and procedure" or in fact abridges or modifies a "substantive right" and extends the jurisdiction of the District Court. This, in turn, requires exploration of the intended coverage of the phrase "practice and procedure" of the federal courts.

C. The Meaning and Scope of the Phrase the "Practice and Procedure" of the Federal Courts.

The Rules Enabling Act was first enacted on June 19, 1934, c. 645, 48 Stat. 1064. The House Report stated that its purpose was to "promote simplicity and uniformity of practice in all Federal courts" (H. Rep. 1829, 73d Cong., 2d Sess. (May 30, 1934)).

In *Sibbach* v. *Wilson & Co.*, 312 U.S. 1, 10 (1941), the Court stated that the Rules Enabling Act "was purposely restricted in its operation to matters of pleading and court practice and procedure", and that *caveats* in the Act "emphasize this restriction".

The Supreme Court has often recognized that it is restricted in its rule-making powers, and has invalidated

* As stated in *Alameda Oil Company* v. *Ideal Basic Industries, Inc.*, 326 F. Supp. 98, 103 (D.Col. 1971), class members will be bound by a judgment in a Rule 23 action "even though they may not be actually aware of the proceedings."

its own rules where they have exceeded the scope of its authority under the Rules Enabling Act. *Hanna* v. *Plumer*, 380 U.S. 460, 471 (1965); *Sibbach* v. *Wilson & Co., supra*, 312 U.S. 1, 10 (1941); *Meek* v. *Centre County Banking Co.*, 268 U.S. 426 (1925); *Davidson Marble Co.* v. *Gibson*, 213 U.S. 10, 19 (1909); *J. B. Orcutt Company* v. *Green*, 204 U.S. 96, 102 (1907); *Hudson* v. *Parker*, 156 U.S. 277, 284 (1895).

Realistically, as Mr. Justice Douglas stated in his dissent to the proposed Rules of Evidence, the Supreme Court does not really prescribe the rules,—it is done by the Advisory Committee, and the Supreme Court is a mere conduit.*

Mr. Justice Douglas, in his dissent, expressed doubt whether rules of evidence are within the purview of the Rules Enabling Act:

> "The words 'practice and procedure' in the setting of the Act seem to me to exclude rules of evidence. They seem to me to be words of art that describe pretrial procedures, pleadings, and procedures for preserving objections and taking appeals" (56 F.R.D. 185).

Then Chief Judge Friendly,—making it clear that he spoke only for himself and not for the other members of this Court,—referred to Mr. Justice Douglas' views as to whether the proposed Rules of Evidence were within the

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* "Second, this Court does not write the Rules, nor supervise their writing, nor appraise them on their merits, weighing the pros and cons. The Court concededly is a mere conduit. Those who write the Rules are members of a Committee named by the Judicial Conference. The members are eminent; but they are the sole judges of the merits of the proposed Rules, our approval being merely perfunctory. In other words, we are merely the conduit to Congress. Yet the public assumes that our imprimatur is on the Rules, as of course it is" (56 F.R.D. 185).

Mr. Justice Black also stated, with respect to the 1966 amendments, that the advisory "committees, not the Court, wrote the rules * * * [T]he Court's transmittal does not carry with it a decision that the amended rules are all constitutional" (383 U.S. 1032 (1966)).

Enabling Act, and state that I share the doubts Mr. Justice Douglas has voiced on that subject".*

Former Mr. Justice Arthur J. Goldberg, referring to the legislative history of the initial Rules Enabling Act, stated: "As I read the legislative record [as to the Rules Enabling Act], this was only designed for housekeeping rules", whereas the proposed Rules of Evidence dealt with "substantive rules", as to which "Congress should initiate and enact affirmative legislation" (Hearings, Feb. 8, 1973, at p. 142).

Congress itself deemed the proposed Rules of Evidence as not included within the "practice and procedure" authorization of the Rules Enabling Act. Accordingly, by Public Law 93-12, approved March 30, 1973, it provided that the Rules of Evidence "shall have no force or effect except to the extent, and with such amendments, as they may be expressly approved by Act of Congress" (87 Stat. 9). And to highlight that the Supreme Court, in prescribing the Rules of Evidence, had assumed a legislative function, the Act is entitled one "To promote the separation of constitutional powers".

The House debate on the proposed Rules of Evidence indicated that many legislators deemed the Supreme Court's authority to promulgate rules as limited to "technical procedural matters" and "housekeeping court procedures",** whereas rules of evidence are "substantive".

With this clarification of the scope of the term "practice and procedure", there may be considered whether the change made in Rule 23 by the 1966 Amendment is a mere matter of "practice and procedure" or does, in fact, abridge or affect a substantive right.

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* Hearings before the Special Subcommittee as to Rules of Evidence, Feb. 22, 1973, 93d Cong., 1st Sess., Serial No. 2, p. 246 (the "Hearings"); Statement of Henry J. Friendly, Chief Judge (*Id.* at 261, repeated also at p. 246).

** Cong. Rec. March 14, 1973, Vol. 119, No. 40, at H 1722, H 1723 and H 1727.

D. The "Unprecedented" Change Made by the 1966 Amendment to Rule 23 and Its "Radical Extension" of the District Court's Power to Bind to a Judgment Members of a Class Not Before It.

Old Rule 23(a)(3),—which covered the "spurious" class action,—was "merely a permissive joinder device in which the right and liability of each individual plaintiff is distinct and no member of the 'class' is bound by a judgment who does not join as plaintiff or intervenor" (*Schatte* v. *International Alliance*, 183 F.2d 685, 687 (9th Cir.), *cert. denied*, 340 U.S. 827 (1950)).

Oppenheimer v. *F. J. Young & Co.*, 144 F.2d 387, 390 (2d Cir. 1944),

> "adverted to the settled rule in the Second Circuit that members of the class who are not joined in such a class suit will not be affected by the decision. In other words, *the decision will only be res judicata as to the plaintiffs and parties who have intervened.*"

Accordingly, the only persons who could be bound by a judgment under former Rule 23(a)(3) are those who become actual parties, either through voluntary intervention or by service of process in accordance with normal "due process" requirements for a lawsuit,—requirements governed by *International Shoe Co.* v. *Washington*, 326 U.S. 310 (1945) and *Hanson* v. *Denckla*, 357 U.S. 235 (1958).

The 1966 Amendments made a basic and radical change in the substantive law, modified a major "substantive right" and extended the District Court's jurisdiction to bind to a judgment persons over whom it previously had no such power because not before the Court.

Moore summarizes the distinction between the old Rule and the new Rule as follows:

> "The most significant difference between the new (b)(3) class suit and the former 'spurious' class action

is the *expansion of the reach of the judgment,* which now binds all members of the class who do not exclude themselves; previously, only those members who intervened in the action were bound by its result" (3B J. MOORE, *Federal Practice*, ¶23.45[1] at 23-701-2 (2d Ed. 1974) (footnote omitted)).

American Pipe & Construction Co. v. *Utah, supra,* explains that under the former Rule, "putative members of the class who chose not to intervene or join as parties would not be bound by the judgment" (414 U.S. at 547), whereas under the new Rule, a member of the class to whom a notice is mailed and who does not opt out "must abide by the final judgment whether favorable or adverse" (414 U.S. at 549).

E. Issues as to Binding Persons to a Judgment, *Res Judicata,* Collateral Estoppel and Estoppel by Judgment Are Matters of Substantive Law, and a Rule With Respect to Such Matters Affects a "Substantive Right."

A plaintiff's purpose in suing is to obtain a judgment and a defendant's objective is to defeat a judgment. Rules of evidence are merely steps used to obtain or defeat the judgment and, in such sense, become substantive in nature, but not to the same extent as the judgment itself. It must be for this reason that Congress deemed the rules of evidence not to be included in the phrase "practice and procedure", but to be of a substantive nature outside the Supreme Court's rule-making power. Otherwise, rules of evidence are normally deemed part of procedure,* if that

* Wigmore states that "the law of Evidence is a part of the law of Procedure" (1 J. H. Wigmore, *Evidence,* §5 at 159 (3d Ed. 1940)).

Professor Moore, in his recent article on "Congress, Evidence and Rulemaking" (co-authored with Bendix), states:

> "Rules of evidence are clearly within the Supreme Court's rulemaking power. They are procedural, for they govern the presentation of facts to court or jury, enabling the trier to apply relevant principles of substantive law on the basis of the facts adduced" (84 Yale L.J. 9, 11-12 (Nov. 1974)).

term is given a broad interpretation, rather than the restrictive one applied to it by both Mr. Justice Douglas in his dissenting opinion, and by Congress.

If, therefore, rules of evidence are deemed substantive, and therefore beyond the Supreme Court's power to prescribe, *a fortiori* would issues of the binding effect of a judgment and *res judicata* be substantive and outside the Supreme Court's rule-making authority.

In *California Apparel Creators* v. *Wieder of California*, 162 F.2d 893, 896-7 (2d Cir.), *cert. denied*, 332 U.S. 816 (1947), Judge Clark, after describing a Rule 23(a)(3) class action as "merely a device of permissive joinder * * * [which] does not grant authority to adjudicate finally rights as to nonappearing parties," held that inasmuch as potential class members were not before the court, "*we cannot give judgment as though they were*", *since the court cannot "confer any additional substantive rights upon the plaintiffs suing"*,—clear recognition that to bind to a judgment parties not before the court, as alleged members of a class, affects "substantive rights".

Numerous cases establish that the issue as to the binding effect of a judgment, *res judicata*, estoppel by judgment or collateral estoppel, are also matters of substantive law. The issue most frequently arises in diversity cases since under *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938) matters of substantive right, unlike matters of "practice and procedure", must be determined by the law of the forum state.

In *Priest* v. *American Smelting & Refining Co.*, 409 F.2d 1229, 1231 (9th Cir. 1969), the Court stated:

> "Since federal jurisdiction in this case is based upon diversity of citizenship, the district court and this court must apply the substantive law of the forum state, the State of Washington. See 28 U.S.C. §1652 (1964); Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S.Ct.

817, 82 L.Ed. 1188; Davis v. Aetna Life Insurance Co., 9 Cir., 279 F.2d 304, 307. *The substantive law of a state includes the law pertaining to res judicata.* Gramm v. Lincoln, 9 Cir., 257 F.2d 250, 255 n. 6. It must therefore, we believe, also include the law pertaining to collateral estoppel. See Centennial Insurance Company v. Miller, E.D.Cal., 264 F.Supp. 431, 433."

Ritchie v. *Landau*, 475 F.2d 151, 154 (2d Cir. 1973), states:

"In a diversity action in federal court the state law is controlling on the question of the applicability of the collateral estoppel doctrine to a given set of circumstances."

Lynne Carol Fashions, Inc. v. *Cranston Print Works Co.*, 453 F.2d 1177, 1179 (3d Cir. 1972), held that *Erie* requires a federal court to "apply the substantive law of the state in which it sits" and that the issue of collateral estoppel "is one of substance as distinguished from one of procedure."

Breeland v. *Security Insurance Co. of New Haven, Conn.*, 421 F.2d 918, 921 (5th Cir. 1969), holds that "Because this is a diversity case, the law of the state where the District Court sat controls questions of res judicata and estoppel."

Furthermore, Rule 23, in its extension of the Court's power to bind persons to a judgment, requires some method of identifying the persons bound. The method selected, of course, is notice to members of the class, either mailed to their last known address or published somewhere.

Since the members of the class are those who do not opt out, the effect is that when the court renders a judgment binding on all members of the class, it has succeeded only in identifying those persons not bound by the judg-

ment; the persons bound by the judgment may still be unknown. But, as stated in *Chicago, Rock Island & Pacific R.R. Co.* v. *Schendel,* 270 U.S. 611, 620 (1926), "Identity of parties is not a mere matter of form, but of substance."

Binding unknown and unidentified persons to a judgment is not a novel concept in the law, and is often necessary, as in the case of unknown heirs. However, "Jurisdiction to sue such persons must be obtained in pursuance of some statute, since otherwise there is no authority to proceed against them as unknown persons, * * *. And where such a *statute providing a constitutional method of procedure* has been followed, the unknown persons are bound by the judgment to the same extent as if they had been named." (I Freeman, *Judgments,* §416 at 906 (5th ed.)).

Presumably, Congress could enact a statute "providing a constitutional method of procedure" which would enable binding parties who may be unknown and unidentified when the judgment is entered. But clearly, this cannot be accomplished through a court rule, in view of the restrictive nature of the Rules Enabling Act.

This basic principle, inherent in our jurisprudence, that an unknown and unidentified person can be bound by a judgment in an action only by "statute providing a constitutional method" has not been changed by any known decision of the Supreme Court, and cannot be changed by a rule of procedure adopted by the Supreme Court.

In *Davidson Marble Co.* v. *Gibson, supra,* 213 U.S. 10, 19 (1909), a rule of Court provided that any special appearance had to include a provision that if the special appearance was denied, the same document constituted a general appearance, which had the effect of subjecting the party to the jurisdiction of the Court and binding him to a judgment. This rule was held invalid because "the jurisdiction of the Circuit Courts is fixed by statute", and "it was beyond

the power of the Circuit Court to make and enforce a rule which * * * transforms an objection to the jurisdiction into a waiver of the objection itself."

Meek v. *Centre County Banking Co., supra,* 268 U.S. 426 (1925), exemplifies the extent to which the Supreme Court will invalidate even its own order, when it appears in an adversary proceeding to have affected a "substantive" right. That case involved General Order in Bankruptcy No. 8, promulgated by the Supreme Court under its rule-making power granted by Congress under Section 30 of the Bankruptcy Act. 11 U.S.C. §53. The General Order authorized any member of a partnership, without the consent of his other partners, to seek a bankrupty adjudication for the partnership. Such order did not mean that the partnership would in fact be adjudicated a bankrupt, since the non-consenting partners could resist the adjudication, and the determination would then be made on the merits and everyone had the opportunity for his day in court before judgment.

Nevertheless, the Supreme Court, finding no express authority in the Bankruptcy Act for a voluntary partnership petition when one partner objected, deemed its own order as going beyond matters of rule, form and procedure, and as affecting a "substantive" right, which the Court was not empowered to do. Accordingly, the Supreme Court invalidated its own order.

The forced general appearance in *Davidson Marble Co.* v. *Gibson, supra,* and the adjudication in bankruptcy in *Meek* v. *Centre County Banking Co., supra,*—involving parties actually before the Court, with full knowledge of the Court proceedings,—is far less drastic than rendering judgment affecting thousands of persons not before the Court, and who may never even have heard of the case in which they are held to be members of a class. There could hardly be a clearer case of a rule which affects a "substantive right".

F. Until 1966, the Advisory Committee Consistently Refused to Sanction a Rule Whereby a Judgment Could Be Binding on a Class Member Who Did Not Become an Actual Party Through Joinder or Intervention, Because It Deemed That Such a Rule Was Not a Matter of "Practice and Procedure" but Would Modify a "Substantive Right."

The keynote for the Federal Rules of Civil Procedure prescribed in 1938, as a result of the Rules Enabling Act, passed June 19, 1934 (48 Stat. 1064), was sounded by Chief Justice Hughes before the American Bar Association, in which he stated that the Rules would be prepared on the basis of no "violation of any substantive right" (21 ABAJ 340, 342 (June 1935)). Until 1966, the Advisory Committee was always guided by this *caveat*.

Rule 23(a), as prescribed in 1938, was extremely brief. It covered the three classic types of class action, the so-called "true" class, covered by subdivision (1); the "hybrid" class, covered by subdivision (2); and the "spurious class", covered by subdivision (3).*

Professor James W. Moore proposed a provision, but limited to subdivision (1), to the effect that members of a "true" class should be bound by a judgment. He explained

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* Former Rule 23(a) reads as follows:

"(a) Representation. If persons constituting a class are so numerous as to make it impracticable to bring them all before the court, such of them, one or more, as will fairly insure the adequate representation of all may, on behalf of all, sue or be sued, when the character of the right sought to be enforced for or against the class is

(1) joint, or common, or secondary in the sense that the owner of a primary right refuses to enforce that right and a member of the class thereby becomes entitled to enforce it;

(2) several, and the object of the action is the adjudication of claims which do or may affect specific property involved in the action; or

(3) several, and there is a common question of law or fact affecting the several rights and a common relief is sought."

his position in a law journal article,* in which he stated that "The law on class actions is inextricably bound up with jurisdiction, and the binding effect of the judgment * * *." Accordingly, his limited proposal as to the binding effect of the judgment, relating only to subdivision (1), covering "true" class actions, was as follows:

> "(b) *Effect of Judgment. The judgment rendered in the first situation is conclusive upon the class;* in the second situation it is conclusive upon all parties and privies to the proceeding, and upon all claims, whether presented in the proceeding or not, insofar as they do or may affect specific property involved in the proceeding; and in the third situation it is conclusive upon only the parties and privies to the proceeding."

The Advisory Committee rejected this provision, simply stating:

> "The Committee consider it beyond their functions to deal with the question of the effect of judgments on persons who are not parties" (Report of the Advisory Committee on Rules for Civil Procedure, Notes on Rule 23 at 60 (Apr. 1, 1937)).

Professor Moore stated the reason his proposal was rejected:

> "This was due to the feeling that such a matter was one of substance and not one of procedure" (*Federal Class Actions—Jurisdiction and Effect of Judgment*, Moore & Cohn, 32 Ill. Law Rev. 555, 556). See also 46 Col. L. Rev. 818, 824.

The original Rules of Civil Procedure adopted in 1938 provided in Rule 14(a), as to third-party practice, that:

> "The third-party defendant is bound by the adjudication of the third-party plaintiff's liability to the plain-

* Federal Rules of Civil Procedure: Some Problems Raised by the Preliminary Draft," 25 Geo. L.J., 551, 571 (1937).

> tiff, as well as of his own to the plaintiff or to the third-party plaintiff."

In the 1948 Amendments, the Advisory Committee deleted this sentence from Rule 14(a), and explained that it did so "because the sentence *states a rule of substantive law* which is not within the scope of a procedural rule. *It is not the purpose of the Rules to state the effect of a judgment*" (Advisory Committee, Notes, 5 F.R.D. 433, 448 (1946)).

In 1955 the Advisory Committee proposed to amend Rule 23 to include a possibility that absent persons might be bound by a judgment, but the proposal was rejected. The Advisory Committee apologized that "The amended rule does not undertake to regulate the effect of res judicata upon the judgment in a class action". (See 12 Wright & Miller, *Federal Practice and Procedure* at 596.)

In 1964, the Advisory Committee first proposed to modify the provisions as to the "spurious" class action to bind class members who had not intervened, but received a mere notice. It was proposed to amend Rule 23(b)(3) to expand the spurious class action, and to amend Rule 23(c)(2) to provide as follows (34 F.R.D. 325, 386):

> "The judgment in an action maintained as a class action shall extend by its terms to the members of the class, as defined, whether or not the judgment is favorable to them".

The Advisory Committee notation on these proposed amendments, in bold face type, made the following statement (34 F.R.D. 395):

> **"Special Note To Bench And Bar: The Advisory Committee recognizes that the proposal embodied in subdivision (b)(3) and the related subdivision (c)(2) is novel. Accordingly, the Committee will particularly welcome comments on this proposal."**

The Advisory Committee could hardly have made clearer the unprecedented nature of its proposal to bind to a judgment persons who were not parties actually before the Court, but merely made part of a class by court rule.

However, the substance of the proposed 1964 Amendments, namely, the binding to a judgment parties not before the Court, except as members of a class, was included in the final Rules as adopted in 1966.

The then Advisory Committee totally disregarded the view of the original Advisory Committee that to deal with the question of the effect of judgments on persons who are not parties is, as Moore stated, a matter "of substance and not one of procedure". Though the law is so clear that the issue of a judgment and *res judicata* is a substantive matter, and the Advisory Committee had consistently rejected any suggestion of including such matters in its Rules, in 1966, it made such unprecedented, radical and sweeping changes, without any comment or discussion of this very significant aspect, or any consideration whether the proposed change modified any substantive right, contrary to 28 U.S.C. §2072, or extended the District Court's jurisdiction, contrary to Rule 82. All the Advisory Committee said is that "on a realistic view, it would seem fitting for the judgments to extend to the class" (39 F.R.D. at 99). Perhaps, as Judge Friendly stated with respect to the proposed Rules of Evidence, the error lay in "too ready acceptance, without opportunity for any full debate" (Hearings, p. 88, *supra,* at 246).

By calling absent, unknown and unidentified persons "members of the class" whose interests are "fairly and adequately" protected by the class representative, the Advisory Committee used what Judge Clark has fittingly described as "the process of hypostasis of these nameless and as yet disembodied spirits." (*All American Airways* v. *Eldred,* 209 F.2d 247, 249 (2d Cir. 1954)).

In short, Rule 23 modified "substantive rights", "in the guise of regulating procedure", contrary to the interdiction of *Sibbach* v. *Wilson & Co., supra,* 312 U.S. 1, 10 (1941).

POINT IV

Rule 23(b)(3) is invalid in empowering a Federal Court to acquire jurisdiction over persons anywhere in the world, merely by mailing them a notice and binding them to a judgment, if they do not opt out.

Rule 23(b)(3) also extends the jurisdiction of United States District Courts in violation of Rule 82.

The reach of Rule 23(b)(3) is extensive. It covers both plaintiff and defendant classes. It grants the District Court power and jurisdiction over all members of both types of classes. It applies in diversity actions and in actions arising under laws of the United States. A mere "notice" is all that is needed to bind to a judgment hundreds, thousands, or even millions of unidentified persons all over the United States, and perhaps all over the world.

In the traditional non-class action, where one or more persons sue one or more defendants, basic concepts of due process of Constitutional dimension are applicable. These include the "traditional notions of fair play and substantial justice", of *Milliken* v. *Meyer,* 311 U.S. 457, 463 (1940); the "certain minimum contacts" with "the territory of the forum", of *International Shoe Co.* v. *Washington,* 326 U.S. 310, 316 (1945); and acts "invoking the benefits and protections" of the laws of the forum state, of *Hanson* v. *Denckla,* 357 U.S. 235, 253 (1958). That these concepts retain viability was made clear in *Leasco Data Processing Equipment Company* v. *Maxwell,* 468 F.2d 1326, 1340 (2d Cir. 1972), in reaffirming "the modern notions" that where a person "has acted within a state or sufficiently caused consequences there, he may fairly be subjected to its judicial jurisdiction even though he cannot be served with process in the state".

The foregoing cases evidence the most modern "due process" requirements before a court can exercise judicial jurisdiction over a party outside the forum.

The Advisory Committee Notes on Rule 23 provide for a notice "designed to fulfill requirements of due process to which the class action procedure is of course subject" (39 F.R.D. at 107), *citing Hansberry* v. *Lee*, 311 U.S. 32 (1940) and *Mullane* v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950).

A. The "Notice" Requirement of "Due Process" in a Class Action

The ultimate objectives of "notice" in a class action and "process" in ordinary litigation are identical,—to subject a person to the jurisdiction and power of the federal court, so that such court can affect his substantive rights and bind him to a judgment. Accordingly, the constitutional aspect of due process is not basically different in an individual action from a class action, in which, as stated in *Hansberry* v. *Lee*, *supra*, 311 U.S. at 42, "the requirements of due process and of full faith and credit" must also be satisfied. If anything, the procedure "designed to fulfill requirements of due process" should be more rigid in a class action, where there may be hundreds of thousands of litigants whose rights are determined in a dragnet situation.

Judge Frankel early articulated the hazards:

> "The courts are not free, as they were before July 1, to treat the class action allegation as merely a permissive invitation to joinder. The authorization of a class suit has a grave significance now. It portends binding judgments for scores or hundreds of people who are not before the court in the usual way. I would suspect that the courts will not be insensitive to such potentially sweeping consequences."*

* Frankel, J., "Amended Rule 23 From a Judge's Point of View", 32 ABA Antitrust L. J., 295, 297 (1966).

Judge Lumbard's dissent in *Eisen* v. *Carlisle & Jacquelin*, 391 F. 2d 555, 570 (2d Cir. 1968) observed that in class actions with a large number of "potential plaintiffs living in every state of the union and in almost every foreign country * * * a substantial proportion of its membership will have no idea whatever that they belong to it."*

Hansberry v. *Lee* was cited in the Advisory Committee Notes to show that the notice to class members prescribed by Rule 23(c)(3) "fulfill(s) the requirement of due process."

Hansberry is here relevant only for the general proposition that it is possible, consistent with due process, to have a class action in which members of the class who are parties "may bind members of the class or those represented who were not made parties to it" (p. 41). But *Hansberry* prescribes basic principles governing due process which, it is submitted, do not bear the remotest relationship to the "notice" requirement of Rule 23(c)(2).

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* Illustrative of the inability of members of a class to understand the significance of a printed notice are the responses received from members of the class in the Antibiotics case. A collection of some of the responses to the notices sent out by mail in North Carolina appears in *"Processing the Consumer's Claim"*, 41 ABA Antitrust L.J., 257, 267.

> "Dear Mr. Clerk: I have your notice that I owe you $300.00 for selling drugs. I have never sold any drugs, especially those that you have listed. I have sold a little whiskey once in a while though."
>
> "Dear Mr. Clerk: I would like to know why I am a party to this action that I don't know nothing about. Who made me a party to anything? (I am a democrat.)"
>
> "Dear Sir: Our son Bill is in the Navy stationed in the Carribean some place. Please let us know exactly what kind of drugs he is accused of taking. From a mother who will help if properly informed. A worried mother Jane Doe."
>
> "Dear Mr. Morgan: I received your card about the lawsuit and I would like to know how much I owe and can I pay it off by the month so I won't have to go to court? If I can pay by the month, I will do just that as soon as I hear from you."

First, *Hansberry* v. *Lee* reaffirmed the "principle of general application in Anglo-American jurisprudence that one is not bound by a judgment *in personam* in a litigation in which he is not designated as a party or to which he has not been made a party by service of process" (p. 40).

Second, *Hansberry* states that "due process" requires a procedure which "fairly insures the protection of the interests of absent parties who are to be bound by it" (p. 42).

Third, *Hansberry* states that if "the members of the class who are present are, by generally recognized rules of law, entitled to stand in judgment for those who are not", then it will "assume for present purposes that such procedure affords a protection to the parties who are represented, though absent, which would satisfy the requirements of due process and full faith and credit" (p. 43).

Having stated such principles applicable to due process, *Hansberry* concluded that "the procedure and the course of litigation sustained here by the plea of *res judicata* do not satisfy these requirements" (p. 44).

Eisen v. *Carlisle & Jacquelin*, *supra*, 417 U.S. 156, 176 (1974), stressed that the Rule 23 notice is "an unambiguous requirement * * * intended to insure that the judgment, whether favorable or not, would bind all class members who did not request exclusion from the suit". Despite such effect of a Rule 23 notice in binding all class members to a judgment, the Rule does not even purport to comply with the standards for class representation prescribed by *Hansberry*. It sets no standard as to whether "the representative parties will fairly and adequately protect the interests of the class" (23(a)(4)),—the key to "due process", in addition to the notice requirement. The Rule as to what is needed to be a representative party is vague, undefined, and so lacking in criteria as to violate the due process and equal protection guarantees of the Constitution.

And Mr. Justice Black, appalled at the absence of "carefully prescribed legal standards enacted to control class suits" in the 1966 Amendments, stated:

> "It seems to me that they place too much power in the hands of the trial judges and that the rules might almost as well simply provide that 'class suits can be maintained either for or against particular groups whenever in the discretion of a judge he thinks it is wise' " (383 U.S. at 1035 (1966)).

State legislatures have traditionally prescribed requirements for service of process in individual suits, consistent with current conceptions of due process. Rule 4, as to service on a party not an inhabitant of or found within the state in which the District Court is held, authorizes service in the manner prescribed in the state. Certain specific federal statutes also authorize nationwide jurisdiction.

The requirements for service of process, as set forth in Rule 4, contain nine separate subdivisions, many with further subdivisions, and Rule 4 occupies four large printed pages, all designed to satisfy due process requirements.

Rule 23(c)(2), the "due process" counterpart of Rule 4, which also seeks to bind parties to a judgment, merely devotes a few lines to method of service:

> "[T]he court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort."

This provision falls far short of satisfying the requirements of *Hansberry* v. *Lee,* as to "process" for class members.

B. The "Adequate Representation" Requirement of "Due Process" in a Class Action

Hansberry v. *Lee, supra,* 311 U.S. at 42-3, establishes that basic to due process in a class action is "adequate representation". As the Court there stated:

"It is *familiar doctrine* of the federal courts that members of a cla[illegible] present as parties to the litigation may be bound by the judgment where they are in fact *adequately represented* by parties who are present * * *."

The Advisory Committee Notes elide this basic consideration by simply stating that the Rule sets forth "the desired qualifications of the representative parties". The Rule, however, merely states that "(4) the representative parties will fairly and adequately protect the interests of the class".

The Advisory Committee Notes, referring to the situation before the proposed 1966 Amendments, define the "'true' category" of class actions as "involving 'joint, common, or secondary rights'", and "the 'hybrid' category, as involving 'several' rights related to 'specific property'"; and state that "the judgments in 'true' and 'hybrid' class actions would extend to the class" (39 F.R.D. 98). It also states that "the judgment in a 'spurious' class action would extend only to the parties, including intervenors" (39 F.R.D. 98).

Such language of *Hansberry* as to being "adequately represented" was written in 1940, 26 years before the 1966 Amendments. The "familiar doctrine" to which it referred must therefore be read in terms of the type of class actions in which an absent party could then be bound by a judgment, if "adequately represented", namely, the "true" and "hybrid" class actions.

Accordingly, the above-quoted statement in *Hansberry* v. *Lee* as to "familiar doctrine" that a party may be bound by a judgment if "adequately represented" did not and could not refer to a class action of the type authorized by former Rule 23(a)(3),—the "spurious" class action in which the only parties who could be bound by a judgment were those who intervened; and in which an absent party

could not be bound, whether or not "adequately represented".

Moore noted the importance, prior to 1966, of

> "the type of class action involved—whether true, hybrid, or spurious. The reason this factor was important was that the res judicata effect of the judgment was not the same in all three types of class actions; and *this had a bearing on what constituted adequate representation.*"
>
> * * *
>
> "The question of adequate representation was very important in the true class suit under the original rule, for there a judgment on the merits bound all the members of the class and *adequate representation was essential to due process of law*" (3B J. Moore, *Federal Practice*, ¶23.07 [1] at 23-353 (2d ed. 1974)).

In all the cases which gave rise to such "familiar doctrine", there was always a real, *bona fide* plaintiff, who had an actual personal stake in the action and a personal interest in its outcome,—rather than merely a nominal plaintiff used by a lawyer to bring a class action to create a substantial legal fee.

Thus, the classic case of *Supreme Tribe of Ben-Hur* v. *Cauble*, 255 U.S. 356 (1921), involved a fraternal benefit association which had issued policies to its members containing certain benefits adversely affected by a reorganization which created a new class of benefit certificate holders. Existing benefit certificate holders instituted suit to determine the validity and binding effect of the reorganization. The parties to the action were thus true parties, having a personal stake, and all the c benefit certificate holders " 'had a common but indivisible interest.' " Therefore it " 'was strictly a true class suit, presenting questions of common interest to all the members of Class A and affecting their joint interests in funds and in internal management of the society' " (p. 361).

In *Hansberry* v. *Lee, supra*, 311 U.S. 32, 44 (1940), the class consisted of persons who had signed restrictive agreements, preventing sale of property to a certain racial group,—a provision which directly affected the property interests of plaintiffs, who brought the suit, and others whom they sought to bind by the judgment as *res judicata*. The Court stated:

> "The restrictive agreement did not purport to create a joint obligation or liability. * * * It is plain that in such circumstances all those alleged to be bound by the agreement would not constitute a single class in any litigation brought to enforce it."

Mullane v. *Central Hanover Bank & Trust Co., supra*, 339 U.S. 306 (1950), involved a judicial accounting by a bank for a common fund, in which plaintiff, as did all the class members, had a real interest.

Thus, all decisions before the 1966 Amendments,—such as *Supreme Tribe of Ben-Hur*, *Hansberry* and *Mullane*, and the many forerunners of those cases which led to the formulation of the "familiar doctrine" referred to in *Hansberry*, were all cases of a *bona fide* plaintiff, with a personal stake in the case, and a financial interest in vindicating his position, and, concomitantly, the position of the class, so that he could "adequately represent" the class. This, together with adequate "notice" are the ingredients of "due process" under *Hansberry*.

In *Snyder* v. *Harris*, 394 U.S. 332, 338 (1969), the Court, referring to its consistent interpretation of a jurisdictional statute, stated that "The interpretation of that statute cannot be changed by a change in the Rules". *A fortiori* an interpretation by the Court of the Constitutional requirement of due process "can not be changed by a change in the Rules".

The situation, of course, is vastly different with respect to the new "spurious" class action, as broadened in 1966, to expand "the reach of the judgment" (3B J. Moore,

supra, p. 27), and to bind to a judgment alleged members of a class who, before such Amendments, could not be bound.

In the new class action created by Rule 23(b)(3), the requirement of having a representative party who "will fairly and adequately protect the interests of the class" is generally not met and will not be met.

As Judge Weinfeld stated in *Free World Foreign Cars, Inc.* v. *Alfa Romeo, supra*, 55 F.R.D. 26, 30 (S.D.N.Y. 1972), Rule 23(b)(3) class actions may have "resulted in miniscule recoveries by its intended beneficiaries, while lawyers have reaped a golden harvest of fees".

In *Eisen* v. *Carlisle & Jacquelin, supra*, 417 U.S. 156 (1974), after eight years without trial on the merits, the Court noted that "A critical fact in this litigation is that petitioner's individual stake in the damage award he seeks is only $70" (p. 161), whereas "individual notice to all identifiable class members would cost $225,000, and additional expense would be incurred for suitable publication notice" (p. 167).

The case at bar, though not quite as extreme, is comparable, since plaintiff's stake is $5,000, which would hardly warrant the time, effort and expense required for him to institute this action were he obligated to pay the legal fees and other expense, including the cost of notifying the class.*

The reality of the "adequate representation" aspect of "due process", as applied to the new "spurious" class action created in 1966, was bared in *La Mar* v. *H&B Novelty & Loan Co.*, 489 F.2d 461, 465-6 (9th Cir., 1973), as follows:

> "The difficulty with this position is that compliance with the prerequisite must necessarily be determined

* While, as already noted (p. 4, *supra*), plaintiff owned additional debentures and stock in Sanitas, these were purchased before the alleged fraudulent omission of which he complains, and, therefore, are not involved in this action. However, had he brought a stockholders' derivative action based on the sale of Economy Linen to the limited partnership, then any recovery would redound to the benefit of all his debentures as well as his stock,—not merely to the $5,000 of debentures.

more by examination of the fitness of the counsel of the candidate for representative party status than by the attributes of the candidate. Once the ability of counsel becomes the measure by which compliance with the fourth prerequisite is determined, there remains only a formal and technical reason for insisting that there be a representative party at all."

Judge Weinfeld also recognized this aspect in *Free World Foreign Cars, Inc.* v. *Alfa Romeo, supra,* and stated that Rule 23(a)(4) "is not restricted to the adequacy of legal representation, but also requires that the purported representative have common interests with its members and that there be no existing or potential conflict of interest" (p. 29). This, it may be assumed, means that, to be an adequate representative, plaintiff's objective must be solely to maximize recovery for himself and the class members, and not merely to aid and abet a substantial fee to his counsel.

Judge Friendly, in considering the consequences of "the judicial gloss" placed on Rule 23(b)(3), stated:

"While the benefits to the individual class members are usually miniscule, the possible consequences of a judgment to the defendant are so horrendous that these actions are almost always settled. Generally this is for a figure constituting a small fraction of the amount claimed but large enough to yield compensation to the plaintiffs' lawyers which seems inordinate even in these days of high legal fees." ("Federal Jurisdiction: A General View", pp. 119-20.)

Judge Friendly also stated:

"The supposed justification is the contingent nature of the fee. But there is little real contingency with respect to achieving a substantial settlement once designation as a class suit has been attained in these gargantuan actions" (*Id.* p. 120, fn. 54).

Such recognition of the real objective of the Rule 23 (b)(3) class action establishes that a plaintiff in such a class action is simply a formal vehicle to enable his counsel to achieve the objectives thus described by Judge Friendly; that such a plaintiff does not really sue to "protect the interests of the class"; that he is not and can not be an adequate class representative of the character intended by *Hansberry* v. *Lee*; and that the action starts with both an existing and potential conflict of interest.

It is submitted that the situation involved in this case, —which is typical of the new 1966-type "spurious" class action,—is not the kind of adequate representation which *Hansberry* prescribed as a *sine qua non* of "due process". When *Hansberry* stated that basic to a class action is that "the members of the class who are present are, *by generally recognized rules of law*, entitled to stand in judgment for those who are not" (311 U.S. at 43), it meant a person with a real personal stake in the litigation and not a lawyer who brought a class action with a nominal party plaintiff solely for his own legal fee.*

However, even assuming the most loyal, dedicated plaintiff; who would diligently represent all class members; who is keenly sensitive to his fiduciary obligation to the class; whose sole motivation is maximum recovery for all class members; and who, by the most rigid conceivable standards would be deemed an adequate representative, the situation is not altered. The fact still remains that, before the 1966 Amendments to Rule 23, the District Court lacked jurisdiction and power to bind to a judgment the members of a "spurious" class. The 1966 Amendments changed this,

* This situation as to the new spurious class action should not be confused with the classic stockholders' derivative action, in which a plaintiff may "be a mere phantom plaintiff with interest enough to enable him to institute the action and little more" (*Koster* v. *Lumbermens Mutual Co.*, 330 U.S. 518, 525 (1947)). The basic difference is that in such stockholders' derivative action, all the parties are before the court, and there is not presented the issue of binding absent parties to a judgment, or the due process considerations inherent in Rule 23(b)(3), or the fact that expansion of the District Court's jurisdiction and its affecting substantive rights is being accomplished by rule and not by an act of Congress.

and granted the District Court sweeping power to bind to a judgment tens, thousands, or millions of persons all over the world who were members of the same kind of "spurious" class, through a "notice", lacking precision or definition. The 1966 Amendments thereby extended the "jurisdiction of the United States District Courts" in violation of Rule 82, and did so in a manner which violates "due process".

Snyder v. *Harris, supra,* 394 U.S. 332 (1969), stated (p. 336) that "the adoption of amended Rule 23 did not and could not" make a "change in the scope of the congressionally enacted grant of jurisdiction to the district courts."

The decision ended on the note that (pp. 341-2):

> "[T]he Congress that permitted the Federal Rules to go into effect was assured before doing so that none of the Rules would either expand or contract the jurisdiction of federal courts. If there is a present need to expand the jurisdiction of those courts we cannot overlook the fact that the Constitution specifically vests that power in the Congress, not in the courts".

POINT V

This Court should dismiss the action, since it is entirely void of merit.

Plaintiff's claim that Sanitas fraudulently failed to disclose that its sale of Economy Linen was made to a limited partnership is so void of merit that this Court should exercise its power to dismiss the complaint.

Appeals of cases not yet tried on the merits may be heard as interlocutory appeals taken as of right under 28 U.S.C. §1292(a) or as certified appeals under 28 U.S.C. §1292(b). Or, as in this case, the appeal may be before this Court as a "final disposition of a claimed right" under the doctrine of *Cohen* v. *Beneficial Industrial Loan Corp.,* 337 U.S. 541, 546 (1949), as constituting one of the cases "which finally determine claims of right separable

from, and collateral to, rights asserted in the action, too important to be denied review and too independent of the cause itself to require that appellate consideration be deferred until the whole case is adjudicated".

This Court, in interlocutory appeals from grant or denial of preliminary injunctions "may dismiss the complaint on the merits if its examination of the record upon an interlocutory appeal reveals that the case is entirely void of merit" (*Hurwitz* v. *Directors Guild of America, Inc.*, 364 F.2d 67, 70 (2d Cir. 1966), *cert. denied*, 385 U.S. 971 (1966)). In accord, *Mast, Foos & Co.* v. *Stover Mfg. Co.*, 177 U.S. 485, 495 (1900); *Denver* v. *New York Trust Co.*, 229 U.S. 123, 136 (1913); *U.S. Fidelity Co.* v. *Bray*, 225 U.S. 205, 206, 214 (1912).

This Court's power to dismiss on the merits a case "entirely void of merit" should be no different when the appeal is from "a final disposition of a claimed right", under the doctrine of *Cohen* v. *Beneficial Industrial Loan Corp.*, *supra*, than when it is an interlocutory appeal under 28 U.S.C. §1292.

As already stressed, the plaintiff has asserted that the case involves "really only a single issue of a substantive nature"; namely, Sanitas' failure to disclose that the purchaser of Economy Linen "was in reality a limited partnership" (see p. 6, *supra*). The record, however, shows that this disclosure was made very plainly and very repetitively on September 29, 1972 in the Proxy Statement mailed to all stockholders (pp. 7-8, *supra*).

As previously noted (p. 9, fn., *supra*), plaintiff's real position appears to be that the sale made to a limited partnership, consisting of Sanitas directors and stockholders, was improvident and constituted wrongful corporate conduct. The merits of such position can be adjudicated in *Lacon* v. *Ginsberg*, the stockholders' derivative action now pending in the District Court of Connecticut.

Plaintiff, however, has obviously brought this class action in order to sue Andersen, the accountants, since accountants are known to be financially responsible, to have

adequate insurance and to be fair game for investors whose stocks or bonds went down.

Plaintiff's Reply Memorandum below, having described the alleged omission to disclose that the sale of Economy Linen was to a limited partnership, seeks to show culpability on Andersen's part by complaining of the financial statements audited by Andersen, and asserting that "Andersen's certification to the public was an express invitation for the public to rely on its financial judgment with respect to the material omission alleged * * *" (p. 21),—referring to the alleged failure to disclose that the buyer of Economy Linen was a "limited partnership".

An insurmountable obstacle to this position is that the opinion expressed by Andersen on the financial statements for the year ended June 30, 1972, was rendered on September 14, 1972 (25A-3a), whereas the disclosure of the contract with the limited partnership in the Proxy Statement is dated September 29, 1972.

Accordingly, plaintiff's theory against Andersen is that when, on September 14, 1972, it expressed its opinion on the financial statements of June 30, 1972, Andersen "* * * put its stamp of approval on the subsequent interim statements" which were issued as of September 30, 1972, December 31, 1972 and March 31, 1973, and which plaintiff apparently complains likewise omitted to disclose that the sale was to "a limited partnership"* (25A-6-25A-10). But these interim statements were issued by Sanitas alone. Andersen did not prepare the figures contained in these interim statements, nor render any opinion or certification as to such statements. Nor does Andersen's name even appear therein. Accordingly, there can be no cause of action against Andersen based on any of these three interim statements. See *Gold* v. *DCL Incorporated* (S.D.N.Y. 1973), CCH Fed.Sec.L.Rep., ¶94,036, pp. 94,165, 94,168.

Sufficient appears in this record for this Court to dismiss the action as totally void of merit, particularly as to the claim against Andersen.

* The third interim statement states that "This industrial laundering operation was sold to a limited partnership which included officers and directors of the Corporation among its partners" (25A-9).

Conclusion

It is respectfully submitted that this Court should determine that:

(1) The District Court improperly determined a class consisting of both debenture holders and stockholders represented by plaintiff.

(2) Plaintiff's lawyer may not represent a class consisting of both debenture holders and stockholders, because of their differing interests.

(3) The Supreme Court lacked the power to prescribe Rule 23, as amended in 1966, since such Rule is not limited to "practice and procedure", but abridges and modifies a "substantive right", contrary to 28 U.S.C. §2072.

(4) Rule 23(b)(3) is invalid in seeking to bind persons to a judgment anywhere in the world, by merely mailing them a notice, and also by extending the District Court's jurisdiction in violation of Rule 82.

(5) The case is so entirely void of merit, especially insofar as it relates to Andersen, that this Court should now dismiss the action.

Dated: New York, New York
March 14, 1975

Respectfully submitted,

BREED, ABBOTT & MORGAN
One Chase Manhattan Plaza
New York, New York 10005

EDWARD J. ROSS
JAMES D. ZIRIN
Of Counsel

WILSON & MCILVAINE
135 South LaSalle Street
Chicago, Illinois 60603

Attorneys for Defendant-Appellant
Arthur Andersen & Co.

CHARLES W. BOAND
Of Counsel

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- -x

JAY HANDWERGER,

Plaintiff-Appellee,

-against-

CHARLES GINSBERG, JR., et al
Defendants

-against-

ARTHUR ANDERSEN & CO.,
Defendant-Appellant

AFFIDAVIT OF SERVICE
ON PERSON IN CHARGE

- -x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

MARY KLOEPFER being duly sworn, says: I am employed in the office of Breed, Abbott & Morgan, 1 Chase Manhattan Plaza, New York, N.Y. 10005, attorneys for the defendant-appellant in the above action.

On the 14th day of March, 19 75 between the hours of 9:30 A.M. and 5:30 P.M., I served the annexed

BRIEF OF DEFENDANT-APPELLANT

on the attorney(s) listed below by delivering the same to and leaving the same with the person in charge of said office(s).

Milberg & Weiss, Esqs., Attorneys for Plaintiff-Appellee, One Pennsylvania Plaza, New York, N. Y.

Mudge, Rose, Guthrie & Alexander, Esqs., Attorneys for All defendants except Arthur Andersen & Co., 20 Broad Street, New York, N. Y.

Sworn to before me this
14th day of March 1975

Edna G. Watrous

EDNA G. WATROUS
NOTARY PUBLIC, State of New York
No. 24-8249500
Qualified in Kings County
Certificate Filed in New York County
Commission Expires March 30, 1976

Mary Kloepfer

Mary Kloepfer